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## Section 172 of the Companies Act 2006: Desperate Times Call for Soft Law Measures

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*Section 172 of the Companies Act 2006 has been afforded much attention during Parliamentary discussions on the codification of directors' duties and has since the enactment of the Companies Act 2006 occupied much space in discussions among scholars who share an academic interest in the shareholder/stakeholder debate, in policy documents on law reforms following a series of corporate failures, as well as in company law lecture notes provided by Law Schools across the UK. With the UK leaving the EU, it is a critical time to discuss enlightened decision-making on boards, considering that, arguably, one of the key benefits of joining the EU with regard to UK company law, was that the UK was prompted to consider incorporating provisions affording a certain level of protection to the interests of other constituencies across a wide range of company and securities law Acts and regulations. What often escapes the attention of participants in discussions surrounding s. 172 CA 2006, is the section's limitations not so much in terms of it prioritising the interests of shareholders over the interests of other constituencies, but with regard to its enforcement and utility overall. The purpose of this chapter is twofold. First it aims to shed some light on the background and function of section 172 CA 2006. Secondly, after considering the challenges, shortcomings and dilemmas surrounding the function of this section, it suggests ways forward by proposing a change in the mode of regulating this aspect of managerial conduct. Ample evidence suggests that section 172 CA 2006 in its hard law form will not facilitate the goal of promoting the 'good governance' of companies that have a high impact on society in terms of enlightened decision-making. Thus, the paper aims to advance an important aspect of UK corporate law in the making: namely suggest the use of alternative means available in the soft law sphere, that could support a more pluralistic and democratic formation of corporate decision-making.*

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## I. Introduction

The previous duty to act bona fide in the interests of the company has been substituted by section 172 Companies Act (CA) 2006, which imposes on a director the duty to 'act in a way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole' and in doing so must have regard to a series of factors listed in the section. The factors are: (a) the likely consequences of any decision in the long term, (b) the interests of the company's employees, (c) the need to foster the company's business relationships with suppliers, customers and others, (d) the impact of the company's operations on the community and the environment, (e) the desirability of the company maintaining a reputation for high standards of business conduct, and (f) the need to act fairly as between members of the company.

Section 172 of the Companies Act 2006 has been afforded much attention during Parliamentary discussions on the codification of directors' duties and has since the enactment of the Companies Act 2006 occupied much space in discussions among scholars who share an academic interest in the shareholder/stakeholder debate, in policy documents on law reforms following a series of corporate failures, as well as in company law lecture notes provided by Law Schools across the UK. More specifically, recourse to section 172 CA 2006 in the aftermath of corporate failures has become a norm in a wide range of policy documents from banking law reform regarding the duties of bank directors (Parliamentary Commission on Banking Standards, 2013) to takeover law reform regarding the duties of the target board within a takeover context (Takeover Panel, 2010). A series of recent events have all made evident how imperative it is to deal with good governance across a range of companies, whether private or public, and *ex ante*, rather than *ex post*.<sup>1</sup> More recently, following the employee pension scheme British Home Stores scandal (Dakers, 2016), the 2016 Green Paper on Corporate Governance Reform sought views on, among others, whether there are measures that could increase connection between boards of directors and other groups with an interest in corporate performance such as employees and small suppliers; and whether some of the features of corporate governance that served companies and society well in

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<sup>1</sup> For example: (i) the collapse of British Home Stores (BHS), a privately owned company, and the problems that stem when pensioners of such companies need to be afforded protection by a taxpayer-backed fund, (ii) the collapse of banks and subsequent bailouts of banks deemed 'too big to fail' and (iii) issues that relate to empire building through ill-thought out mergers and acquisitions of companies which eventually collapse, with a grave impact on various constituencies and the societies such companies operate.

relation to listed companies, should be extended to the largest privately-held companies at a time in which different types of ownership are common (Green Paper, 2016).

In light of the above and with the UK leaving the EU, it is a critical time to discuss enlightened decision-making on boards, considering that, arguably, one of the key benefits of joining the EU with regard to UK company law, was that the UK was prompted to consider incorporating provisions affording a certain level of protection to the interests of other constituencies across a wide range of company and securities law Acts and regulations. What often escapes the attention of participants in discussions surrounding section 172 CA 2006, is the section's limitations not so much in terms of it prioritising the interests of shareholders over the interests of other constituencies, but with regard to its enforcement and utility overall. The purpose of this chapter is twofold. First it aims to shed some light on the background and function of section 172 CA 2006. Second, after considering the challenges, shortcomings and dilemmas surrounding the function of this section, it suggests ways forward by proposing a change in the mode of regulating this aspect of managerial conduct. Ample evidence suggests that section 172 CA 2006 in its hard law form will not facilitate the goal of promoting the 'good governance' of companies that have a high impact on society in terms of enlightened decision-making. Thus, the paper aims to advance an important aspect of UK corporate law in the making: namely suggest the use of alternative means available in the soft law sphere, that could support a more pluralistic and democratic formation of corporate decision-making.

The present chapter is divided as follows. The second part of the chapter sheds some light on the background and function of section 172 CA 2006 and how the duty has evolved from a duty to act in the interests of the company to the codified duty of section 172 CA 2006. After considering the challenges, shortcomings and dilemmas surrounding the function of this section, the third part of the chapter provides a discussion on ways forward by proposing a change in the mode of regulating this aspect of managerial conduct. It proposes that a provision along the lines of section 172 CA 2006 should be introduced into the Corporate Governance Code and provides a useful set of justifications for this proposal, as well as an acknowledgement of the challenges that a proposal as such may be faced with.

## II. The Evolution of the Duty to Act in the Interests of the Company

The reform process of the Companies Act 2006 (henceforth CA 2006) aimed to provide clarity and accessibility, align what is good for the company with what is good for society at large and keep legal regulation to the minimum necessary to safeguard stakeholders' legitimate interests (Law Commission, 1999). Codification was supported by the British business community and by prominent organisations such as the London Stock Exchange (Ferran, 1999). The 'enlightened shareholder value' approach adopted in section 172 CA 2006 was seen as the approach '*most likely to drive long-term company performance and maximise overall competitiveness and wealth and welfare for all*' (DTI, 2005). The Rt Hon Margaret Hodge MP, Secretary of State for Trade and Industry, in her Ministerial Statement on the reforms to the duties of the company directors, commented that the provisions of the Companies Act regulating directors' duties could either be seen as a mere codification of the existing law or as a radical change; and section 172 CA 2006 in specific would qualify as a change, as the section links what is good for a company to what is good for a society at large (DTI, 2007).

Section 172 was considered of value insofar as it prompts a change in directors' mind-set and recommends a change in the way in which boards should proceed with their decision-making as a matter of practice, rather than as a matter of liability. The challenge directors are faced with is an obvious one; how should they balance these conflicting interests? It is hard to draw a distinction between the role that the law plays versus the role that economics play in shaping directors' decision-making processes. The distinction between the duties that directors legally owe to the company and the duties that directors owe on an abstract level to their shareholders through free market and competition pressures is blurred. Winter and Van De Loo contrast the role of law to that of economics in relation to regulating the conduct of the board by explaining that whereas law stays at the margins of what boards are doing by focusing on formalities, process and liability (Winter and Van de Loo, 2014), economists take a view on what boards should be doing, and also on how to control boards to ensure that they do it (ibid). Seen in this light, it is evident that, despite section 172 CA 2006 being a hard law duty as incorporated in the Companies Act 2006, it is in fact a provision with a 'soft law' impact on corporate decision-making at best. One could therefore perhaps safely argue that

section 172 CA 2006 adopts an approach which is closer to the law and economics rationale (Fama, 1980; Fama and Jensen, 1983; Jensen and Meckling, 1976), and is worthless as a hard law provision in its own right. This is why section 172 CA 2006 makes more sense when considered in parallel to sections in Chapter 15 of the Companies Act in relation to corporate reporting.

Section 172 CA 2006 appears to represent a compromise between two opposing positions on the nature of the company. The answer to the question of ‘whose interests should directors promote?’ is intricately linked with the question of ‘what should the purpose of the corporation be’ (see eg Dodd, 1932; Berle, 1932). On the reformulation of the duty ‘to act in the interests of the company’ at common law, an important debate which arose concerned whether to adopt a shareholder primacy model or a pluralist model on the redrafting of the duty. A more pluralist approach to the drafting of the section than currently exists, failed on the grounds that it was difficult to provide a safe enforcement mechanism that is alternative to the safe shareholder control mechanism that was already in place. The duty was reformulated on the basis that the duty should reflect modern business needs and wider expectations of responsible business behaviour (DTI, 2005).

## A. Unaltered Aspects of the Duty

The duty at its core has remained unaltered. Section 172 CA 2006, similarly to the old common law duty, continues to impose a subjective test in decision-making, so that the business decision is left to directors, and courts will not interfere in the judgment made (*Re Smith & Fawcett Ltd* [1942]). The section indeed states that directors must act in the way *they* think in good faith will promote the success of the company (ibid; *Regentcrest plc v Cohen* [2001]; *Charterbridge Corp Ltd v Lloyds Bank Ltd* [1970] and *Extrasure Travel Insurance Ltd v Scattergood* [2003]).

Despite the enactment of the enlightened shareholder value approach in section 172 CA 2006, shareholders’ interests remain the primary focus in corporate board decision-making, but the interests of other corporate constituencies are taken into account as a variable in the equation that guarantees that the corporate interest is being served. Section 172 CA 2006 had first given rise to concerns about directors being in breach of their duties if they did not consider every interest group individually in their decision-making (Jopson and Eagleshaw, 2006). However, it remains the case that the duty to act in the interests of the

company has always, save in special circumstances, been owed to the company and not to individual shareholders or any stakeholders separately (*Foss v Harbottle*, [1843]). There are cases that refer to the provision of section 172 CA 2006, albeit briefly, stating essentially the section merely sets out the pre-existing law on the subject. In *Re West Coast Capital (LIOS) Ltd* (2008), it was provided that section 172 CA 2006 did ‘little more than set out the pre-existing law on the subject’. *Re Southern Counties Fresh Foods Ltd* (2008) provided that pre- and post-CA 2006 duties ‘come to the same thing’. Also, Warren J in *Cobden Investments Ltd v RWM Langport Ltd* (2008) stated that the old provision of good faith is ‘reflected’ in section 172 so that the section 172 CA 2006 will most likely be interpreted and evaluated in the same way.

## B. Altered Aspects of the Duty: Ambiguous Terms

The statute is different to prior law insofar as it requires the promotion of the success of the company not on its own right as a separate legal person, but for the benefit of the shareholder constituency as a default priority, and explicitly requires that regard be had to other constituencies when considering what promotes shareholders’ interests, so that the standard of care by which appropriate regard is measured has been altered (Kershaw, 2001: 382–84). At common law the duty expressed in the words of directors acting in ‘the interests of the company’ made clear that the duty of the director was owed to the company, mostly in the sense that the company or those acting on behalf of the company could bring a claim against the wrongdoer to enforce the duty. The importance of the reformed duty lies in the fact that it lists a number of factors which directors are prompted to take into account (section 172 (a)(b)(c)(d)(e)(f) Companies Act 2006). Consideration of other factors and stakeholders’ interests do not come second to shareholders’ interests, but rather constitute a means to an end of serving shareholders’ interests, ideally long-term wealth creating and non-value destroying sustainable interests. Although section 172 does not appear to create a fundamental change to the pre-existing duty, it does however introduce the concept of ‘enlightened shareholder value’ (ESV), otherwise understood as a new approach to management decision-making. The impact of the non-exhaustive list of factors in corporate decision-making remains unclear however. When the duty was first introduced, safe practice followed by boards in order to avoid the potential of incurring liability due to a failure to

abide by the requirements of the duty, was to follow a 'tick-the-box' procedure<sup>2</sup> and to minute that the matters listed in section 172 CA 2006 had been considered before entering into any major board decision (Marshall and Ramsay, 2012). This practice however began to subside, as it remained the case that courts would consider the belief of the director at the time the decision was taken and not the quality of his business judgement, or the factors taken into account for that matter.

The section undoubtedly introduces new terms and concepts, which differ somewhat to the old common law duty. According to the guidance to the Companies Act 2006 provided by the Department of Trade and Industry, the term *success of the company* reflects what the shareholders of the particular company want to collectively achieve, whilst it is accepted that commercial companies will normally equate success with the company's long-term increase in value (DTI, 2006). Furthermore, it is noted that the company's constitution and the decisions made under it will ultimately reflect what the 'success model' for the particular company is (ibid, columns 255 and 258). What remains unclear, is to what extent the interests of the company and the interests of shareholders overlap. From a political perspective this may have purposefully remained an unsettled matter. As Davies points out in one of his lectures, referring to the interests of the company in an obscure manner may be useful in terms of avoiding political controversy but does not generate transparent law (Davies (2005) at 4).

Beyond legal theory and irrespective of whether the company is considered a legal abstract or a natural person, the duty owed to the company should nevertheless in practical terms, be owed to a specific group of persons (Nourse LJ in *Brady v Brady* [1998] BCLC 20 at 40, CA, who stated that 'The interests of the company, as an artificial person, cannot be distinguished from the interests of the persons who are interested in it'). At common law the interests of the company are equated with those of its shareholders, specifically current and future ones (*Gaiman v National Association for Mental Health* [1971] Ch at 330 'both present and future members'). Also, according to *Brady v Brady*, the 'interests of the company [an artificial person], cannot be distinguished from the interests of the persons who are interested in it'. The term introduced in section 172 CA 2006 'the benefit of its members as a whole', clarifies that this is also the position that the Act adopts. As the Department of

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<sup>2</sup> Despite the note made on the term '*have regard to*' by Rt Hon Margaret Hodge MP, Commons Report, 17 October 2006, column 789, that: 'The words "have regard to" mean "think about"; they are absolutely not about just ticking boxes.'



Trade and Industry (DTI) document provided: *‘the duty is to promote the success for the benefit of the members as a whole—that is, for the members as a collective body—not only to benefit the majority shareholders, or any particular shareholder or selection of shareholders’*.<sup>3</sup>

### C. Enforcement and Utility Related Issues

What remains to be examined is the actual utility of section 172 CA 2006. An assessment of its utility requires an examination of its patterns of enforcement, or lack thereof, an examination of its relationship to other sections of the Companies Act 2006, as well as a discussion of the impact that the duty has had on corporate reporting. There are arguably three spheres in which section 172 CA 2006 operates, namely (i) breach of duty per se (ii) the ‘hypothetical director’ test used in the derivative claim permission stage court hearing and (iii) reporting requirements, more specifically the Strategic Report and the Non-Financial Statement.

### D. Breach of Duty

In relation to the duty’s actual enforcement the picture is grim. As Davies explains, the subjective test inherent in section 172 CA 2006 means that ‘litigation is likely to be relatively uncommon and probably even less often successful’ (Gower and Davies, 9th edn, 2012: 543). As stated: ‘This is because it is very difficult to show that the directors have breached this duty of good faith, except in egregious cases or cases where the directors have, obligingly, left a clear record of their thought processes leading up to the challenged decision’ (ibid). The conclusion that can be drawn in relation to section 172 CA 2006 when discussed through the prism of ‘enforceability’ and accountability, is that although the duty establishes a right, it does not come with a clear remedy, thus making it highly problematic as an accountability mechanism to be used by the company against directors.

Case law post the enactment of the section remains unhelpful in relation to whether the renewed approach towards decision-making that the section aspired to introduce has actually transpired in practice. There are only few cases to date which address the section,

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<sup>3</sup> Department of Trade and Industry, *Ministerial Statements, Companies Act 2006, Duties of Company Directors* (2007) 7–8, quoting Lord Goldsmith, Lords Grand Committee (6 February 2006, col 256) available at [www.berr.gov.uk/files/le40139.pdf](http://www.berr.gov.uk/files/le40139.pdf).

most of which, as outlined above, suggest that it simply codifies the pre-existing law (eg *Re Southern Fresh Foods Ltd* [2008]; *Re West Coast Capital (LIOS) Ltd* [2008]). A judicial review of section 172 CA 2006 provided by Grier provides a good account of the problems associated with bringing an action against the directors using section 172 CA 2006 as a basis (Grier, 2014: 100). Cases that do in fact apply the section have focused on section 172(1)(f), i.e. on the aspect relating to *the need to act fairly as between members of the company* (eg *West Coast Capital (LIOS) Ltd, Petitioner* [2008]; *Hughes and Weiss* [2012]; *Philips v Fryer* [2013]).

One case in particular stands out, as it arguably qualifies as the only case, which refers to the issue of the failure to have regard to the various factors addressed in section 172(1)(a)–(e). In fact, the case does not even involve a claim brought against the directors, but rather a judicial review of the Government’s role as the majority shareholder with regard to the way in which the company was being managed. In *R (People & Planet) v HM Treasury* ((2009) EWHC 3020) permission to apply for judicial review was made, in order to bring proceedings against HM Treasury concerning the handing of its indirect investment in Royal Bank of Scotland (RBS). The Government held an interest in RBS through a 70 per cent shareholding in RBS via a company, UK Financial Ltd (‘UKFI’), which was itself held 100 per cent by HM Treasury. The HM Treasury issues guidance for public sector bodies on how to appraise proposals before committing funds to a policy, programme or project and the Green Book constitutes a set of guidelines which describe how the economic, financial, social and environmental assessments of a policy, programme or project should be combined (‘The Green Book’ Appraisal and Evaluation in Central Government). The argument the applicant made was that through its shareholding, HM Treasury, should have prompted RBS to adopt a policy that was more protective of the environment and of human rights than the one it had in place, in view of the fact that HM Treasury was bound by the Green Book guidelines. The Court found that that the officials conducting the Green Book Exercise had correctly identified the proper way in which social and environmental considerations are to be taken into account in accordance with the duty and that the HM Treasury should not have sought to go beyond that to impose its own policy in relation to combatting climate change and promoting human rights on the Board of RBS. It was found that this would not only conflict with the duties of the board of RBS as set out in section 172(1) CA 2006, but would also have given a real risk to litigation by minority shareholders complaining that the value of their shares had been affected by the Government seeking to impose its policy on RBS.

## E. The ‘Hypothetical Director’ Test

So, where else can one find evidence of the section’s utility if not through its strict enforcement in a case of a breach of the director’s duty? The ‘hypothetical director’ test used in the statutory derivative claim under Part 11 of CA 2006 (sections 260–69) is another part of the Companies Act whereby recourse is made to section 172 CA 2006. The case law on how the court interprets the section, largely reinforces the point that it is the *financial merits* of the claim versus the company’s interests, that the Court will consider. At the second stage of shareholders establishing that they have a *prima facie* case to be given leave by the Court to pursue the derivative claim on behalf of the company, the court must consider whether to grant permission to the shareholder to proceed with the action by reference to a series of factors. By section 263(2)(a) and 263(3)(b) of CA 2006, the court must deny permission if a hypothetical person acting in accordance with the duty to promote the success of the company would not seek to continue the claim (see also *Franbar Holdings v Patel and others* [2009] 1 BCLC 1, *Kiani v Cooper* [2010] 2 BCLC 427 and *Mission Capital Plc v Sinclair and others* [2008]. Case law on the factors that the court takes into account supports this point. In *Iesini v Westrip* (2011), Lewison J listed a number of relevant factors to be taken into account, which include the size and the strength of the claim, the cost of proceedings and the company’s ability to fund proceedings, the ability of potential defendant’s to satisfy any judgment and the impact on company of defeat in terms of costs and the disruption of activities. Mention to the derivative claim highlights the utility of section 172 CA 2006 in this respect and at the same time points to the fact that the set of factors that the court considers are centred around establishing the business case of any decision, rather than enlightened decision-making.

## F. Reporting Requirements CA 2006 and Corporate Governance Code

Clear reference to section 172 CA 2006 is made in the reporting requirements set out in the CA 2006. Reporting requirements in the UK represent the facilitative approach that the Government adopts towards businesses (Ferran: 23). Section 414A CA 2006 requires the board of directors of companies to which the section applies to, to produce a *Strategic Report*. Section 414C(1) CA 2006 outlines the report’s purpose, which is to inform the members of the company and to help them assess how the directors have performed their duty under section 172 CA 2006. Section 414C(4) CA 2006 specifically provides that the review must, to the extent necessary for an understanding of the development, performance

or position of the company's business, include an analysis using financial key performance indicators, and where appropriate, using other key performance indicators, including information relating to environmental matters and employee matters. Sections 414C(7) and 414C(8) CA 2006 provide additional details relating to the content of the strategic report in the case of a quoted company. Section 414C(7) CA 2006 indicates the requirement for the report to include:

(a) the main trends and factors likely to affect the future development, performance and position of the company's business, and (b) information about— (i) environmental matters (including the impact of the company's business on the environment), (ii) the company's employees, and (iii) social, community and human rights issues, including information about any policies of the company in relation to those matters and the effectiveness of those policies.

As of 1 January 2017 The Companies, Partnerships and Groups (Accounts and Non-Financial Reporting) Regulations 2016 implemented the Non-Financial Reporting Directive (2014/95/EU) in the UK applying in relation to financial years commencing on or after 1 January 2017. These amend Part 15 of the Companies Act 2006 by inserting two new sections, namely section 414CA and 414CB following section 414C. These sections now impose a reporting obligation on large public-interest entities, such as listed companies and qualifying partnerships, banks, insurance undertakings and other companies, to disclose relevant non-financial environmental and social information in their strategic reports. Section 414CB sets out the content of the non-financial information statement, which includes environmental matters (including the impact of the company's business on the environment), the company's employees, social matters, respect for human rights, and anti-corruption and anti-bribery matters.

It is apparent that an overlap exists between the enhanced business review that quoted companies (irrespective of their size or the number of their employees) are required to produce as part of the strategic report and the statement imposed by the Regulations, which does indicate that compliance with new section 414CB (1)–(6) is deemed to fulfil some of the requirements for non-financial information contained in Section 414CB(7). Again, mention to the reporting requirements merely highlights the utility of the factors signposted in section 172 CA 2006. In addition to the above requirements, sections 415–18 of the CA 2006 impose a duty to prepare a Directors' Report for each financial year of the company (original Section 417 CA 2006). Also, according to the Corporate Governance Code provision C.2.2, boards are also required to include a 'Viability Statement' in the Strategic Report to investors, which

is assumed to provide an improved and broader assessment of long-term solvency and liquidity.

### III. Proposals for Reform: Challenges and Justification

#### A. Proposal for Reform of the Code: Inclusion of ‘Section F: Relations with Stakeholders’

The Corporate Governance Code implicitly touches upon the aims and objectives which certain aspects of section 172 CA 2006 aspire to achieve, across a wide array of the Code’s provisions. Notably, Principle C.2, does indeed provide for Risk Management and Internal Control, and prompts the board to identify, assess and monitor the principal risks that the company may be subject to in their annual report. Stakeholders’ interests could be seen as part of, as well as separate to, this type of risk assessment. The Code does not explicitly refer to stakeholders or other aims and objectives in the manner in which the wording of section 172 CA 2006 does. The text that could be introduced in the Corporate Governance Code would necessarily require the creation of a new section, namely ‘Section F: Relations with Stakeholders.’ The section would adequately endorse the OECD Principle IV regarding the role of stakeholders in corporate governance which provides that: ‘The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises’ (OECD Principles, 2015: 34.). In this respect the Corporate Governance Code Section F should stipulate that:

##### Main Principle

There should be a dialogue with stakeholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with stakeholders takes place and that during the board’s decision-making process the board has regard (amongst other matters) to—

- (a) the likely consequences of any decision in the long term,
- (b) the interests of the company's employees,
- (c) the need to foster the company's business relationships with suppliers, customers and others,
- (d) the impact of the company's operations on the community and the environment,

- (e) the impact of the company's operations on social and human rights issues,
- (f) the desirability of the company maintaining a reputation for high standards of business conduct.

A provision prompting companies to adopt an enlightened shareholder approach in decision-making is not foreign to other jurisdictions, nor to the needs of current times. An innovative aspect of the Dutch Corporate Governance Code, revised in 2016, which came into effect 1 January 2017, requires the management board to formulate a vision on long-term value creation and a strategy for the realisation of this vision, which has been set in place on the assumption that it ensures that the company devotes sufficient attention to the tenability of the strategy in the long term, stating that when developing the strategy attention should be given to among others, the interests of stakeholders (Dutch Corporate Governance Code, 1.1.1. 'Long-term value creation strategy' 8 December 2016 edition). Long-term sustainable development has similarly been addressed by the International Business Council of the World Economic Forum, which issued 'The New Paradigm, A Roadmap for an Implicit Sustainable Long-Term Investment and Growth Corporate Governance Partnership between Corporations and Investors to achieve' issued in September 2, 2016 (International Business Council of the World Economic Forum, 2016). It has also been established that the South African Corporate Governance Code, the King III (see e.g. Esser, 2014), was one of the pioneers in this respect, as it prompted the board to consider the interests of all legitimate stakeholders and not just those of the shareholders following the stakeholder inclusive model. King IV follows this approach.

My proposal aligns with the concept of Environmental, Social and Governance, which appears in the United Nations Principles of Responsible Investment and refers to extra-financial material information about the challenges and performance of a company on these aspects, enabling shareholders to better assess risks and opportunities. The proposal also aligns with the objective that the private sector is expected to play a large role in the implementation of the UN's sustainable development goals (UN, 'Transforming our world: the 2030 Agenda for Sustainable Development' 21 October 2015) notwithstanding that currently it is reported that fewer than half of global companies plan to engage with the UN's sustainable development goals (SDGs) (Ethical Corporation, 2016).

## B. Challenges to the Proposal

Admittedly, one might object to this proposal insofar as the adoption of a stakeholder friendly provision in the Corporate Governance Code may lend itself to a series of adverse consequences. An argument could well be made that emphasis being placed on the soft law as the guarantor of stakeholders' interests may cut off discussion on hard law reform that could possibly achieve the same objectives in a potentially more secure and transparent manner. At the same time, another argument which could also be made against the proposal put forward concerns the problems that surround compliance with the Corporate Governance Code more generally, especially in light of the fact that any type of compliance with the Code is assumed to be monitored by shareholders, which within the context of shareholders' stewardship, would only ever mean indirect representation of stakeholders (Veldman and Willmott, 2016).

Careful thought has been given to these well acknowledged concerns that arise from the shareholder/stakeholder debate more generally, as well as to the concerns that have been put forward in relation to the false assumption that soft law and the 'comply and explain' mode of regulation are the ideal form of regulation. The present chapter does not claim to offer an all-encompassing solution to the complex set of issues on problems relating to the utility of the corporate governance code in general, to problems relating to the compliance and enforcement of the code and problems with shareholder stewardship. The adoption of a stakeholder friendly provision in the FCA Corporate Governance Code does not aim to substitute *hard law reform* that could possibly achieve the same objectives in a potentially more secure and transparent manner. The proposal made also does not exclude other proposals that advocate in favour of more direct stakeholder governance. Monitoring and enforcement of this principle of the Code is an aspect of this regulatory reform which could be further expanded on by providing other stakeholders with the right to identify non-compliance and lobby for compliance, or by providing the regulatory authority with more powers and transparent procedures to ensure compliance of companies with the Code. Soft law can be seen as a politically palatable option and the proposal put forward also appears to fit the agenda of shareholder stewardship, and further extends it.

Furthermore, it could be easily argued that the recommendation of introducing section 172 of the Companies Act 2006 into the Corporate Governance Code is not only adopting a cautious and a rather safe approach to reform, but that such a proposal may prove equally as ineffective as is the current status quo, if not more so. One should not overlook however that it is often the case that radical proposals, which are harshly unfriendly towards the business community and towards less progressive policy makers, are rarely endorsed. So, in

introducing this proposal, the author has also taken into account what is politically viable in terms of ways forward, as well as a proposal which enables a safe means via which to test within a reasonable time frame the utility of such a proposal. It is beyond the scope of this research to recommend a complete overhaul of the UK's problematic, in many respects, system of 'comply or explain' or problematic architectural framework regarding compliance.

## C. Justification for the Proposal

Adopting such a provision in the UK Corporate Governance Code does not merit value merely because of the need to follow current trends and global or other domestic standards. There are sound reasons for adding such a provision in the Code, which include: (i) enhancing the section's visibility and overall utility, (ii) the limitations of hard law and (iii) necessity, considering the current socio-political environment facing the UK.

### i. Signalling and Enhancing the Section's Utility

Were the section indeed to be placed in the Corporate Governance Code, a question would arise in relation to the section's utility. Is there any indication that shareholders would make use of such a section when exercising their voting, in order to place pressure on boards and to promote what can be considered 'better governance' along the lines of what is outlined in the factors of section 172 CA 2006? It must be acknowledged that a grim picture has been painted of shareholder activism, especially that of institutional shareholders (Hughes, 2009). Nevertheless, the role of shareholders in enforcing the Code remains an important one, even if not the strongest or the sole means available to secure the corporate governance of companies (Section E, Corporate Governance Code). Examples do exist whereby shareholders, as well as other bodies, use the Corporate Governance Code provisions as a useful basis to challenge management on non-shareholder related issues. In May 2017, *Royal Dutch Shell* (RDS) shareholders, including the Church of England, European pension funds and Dutch activists, tabled a resolution for Shell's annual general meeting, asking the company to establish carbon emission reduction targets, sending a signal to the board of the Anglo-Dutch company to set new climate change goals (Vaughan, 2017). *ClientEarth*, a London based law firm, in August 2016 alerted the UK financial regulator to reporting breaches by two oil and gas companies, *SOCO International Plc* and *Cairn Energy PLC*, which failed to adequately disclose climate change risks to their businesses in their 2015 strategic reports (*ClientEarth*, 2016). As a result, the companies updated their disclosure practices as a



direct result of *ClientEarth*'s complaint to the FRC, but the regulator has not made the results of its investigation public (*ClientEarth*, 2017). *TESCO Supermarkets* shareholders protested against *Tesco*'s failure to pay the Living wage to its employees resulting in the taxpayer having to make up the shortfall through tax credit payments at *TESCO*'s AGM (Poulter and Steiner, 2015). *Sports Direct* shareholders similarly protested at its meeting, regarding the firm's pledge to improve working conditions, following the sportswear chain's lawyers' critical report of the company's working conditions, advocating in favour of a new, fully independent review of company practices (BBC News, 2016). More recently, on environmental issues, albeit in the US, *ExxonMobil* investors at *ExxonMobil*'s annual meeting voted with a 62 per cent majority vote in favour of a shareholder proposal calling on the oil and gas giant to assess and disclose how it is preparing its business for the transition to a low-carbon future (Ceres, 2017).

## ii. The Limitations of Hard Law

An argument could be made that there is no need to resort to transposing the rationale of section 172 CA 2006 into the soft law sphere, but rather focus on the section's weaknesses in terms of its enforcement and proceed to the reform of the section per se so as to enhance its own utility and enforceability (eg *Re Southern Fresh Foods Ltd* [2008]; *Re West Coast Capital (LIOS) Ltd* [2008]). Conclusions drawn following a judicial review of section 172 CA 2006 by Grier provide that the few cases which refer to section 172 CA 2006 may be an indication of the following broader problems surrounding hard law provisions within the sphere of directors' duties. An interpretation provided by Grier is that section 172 CA 2006 has not been utilised because: the right provided by the section is not a realistic way of solving a problem involving directors' neglect of stakeholder interests indicates in section 172(1)(a)–(e); most shareholders do not know about the section and if they do, do not care enough to do anything about it; the costs of bringing a petition puts potential petitioners off and even if the petitioner has a point, the bad publicity that would be attracted to the company by a court case, would probably have a deleterious effect on the company's share price; where there are problems with a listed company's directors, by far the easiest solution is for shareholders' to sell their shares; and finally, it is often the case that directors are not worth suing (Grier, 2014).

Beyond the practical reasons usefully articulated by Grier above, another reason against reinforcing the section's hard law utility is the reality of the politics of UK law-

making within the corporate law sphere, which is overall more favourable towards soft law. There are historical reasons behind the evolution of the UK's system of self-regulation, which include the rise of institutional investors which transformed the dynamics that exists within British business to date (Cheffins, 2008). In addition to this, the English version of the US business judgment rule, whereby courts will not interfere in the assessment of the business judgment made by the board of directors, is engrained into the UK legal system, so that the change that many more progressive company law scholars may wish to see effected by the courts, is likely to never come.

### iii. Necessity Amidst Scandals and BREXIT Process

Despite this light regulatory touch, the final justification for reinforcing the Corporate Governance Code through an adoption of an equivalent provision is that of necessity. The scandals of *BHS*, *Sports Direct*, as well as the current uncertainties surrounding the UK's position as the BREXIT negotiations unfold, as well as the decision of the USA to opt out of the Paris Climate Change Agreement in June 2017 (Sevastopulos, Jopson and Clark, 2017), all make it imperative to consider a new approach to prompting businesses to behave in a sustainable manner with due consideration to stakeholders' interests. Especially with the UK leaving the EU, it is a critical time to discuss enlightened decision-making on UK boards (Dallas, 2017). The UK has with its EU membership been prompted to consider the interests of other constituencies across a wide range of company and securities law Acts and regulations. The UK with its entry to the EEC, now European Union, was expected to comply with EU company law legislation and the CA 2006 is one of the opportunities taken to adopt in statutes various EU company law and securities regulation requirements. This will not necessarily remain the case if a key regulatory instrument, such as the Corporate Governance Code, does not give a clear signal that the stakeholder approach is afforded some level of protection. The fear of the UK addressing issues differently in a post BREXIT environment is a real one.<sup>4</sup> There are sound reasons to be weary of a change in this respect in light of the UK's commitment to leave the EU.

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<sup>4</sup> Regarding the need for the UK to maintain its reputation as a hub business activity and investment see the statement of the Parliamentary Under-Secretary of State for Business, Energy and Industrial Strategy, Margot James MP on 7 December 2016 in introducing the Companies, Partnerships and Groups (Accounts and Non-Financial Reporting) Regulations, placing emphasis on the parallel need to re-examine whether certain aspects of company law are cost-effective.

There has been a drastic shift away from the argument made in the early 2000s, put forward in their seminal article by Hansmann and Kraakman (2000), who argued that with the impact of globalisation, company law systems will converge to the more efficient model of shareholder primacy. The Company Law Review Steering Group drafted the duty in such a way so as to prompt directors to take a properly balanced view of the implications of decisions over time and to foster effective relationships with other stakeholders so as to ensure the company's long-term success (Company Law Reform (DTI, 2005)). Arguably it has been the EU influence that has in fact led to the inclusion of other interests into the Companies Act 2006, namely section 172 CA 2006. The codification of directors' duties in the Act in particular, unlike other cases, was not a case of a direct implementation of a particular Directive within this area of company law, but rather part of a broader plan to adopt statutes that would replace the common law, in order for the UK to come closer to the continental European style of legislation. The light touch reform could possibly also be attributed to the fact that the reforms took place in the era of Tony Blair and Patricia Hewitt, the recently 'at the time' appointed Labour government. Ferran explains that, in reviewing the corporate law proposed reforms of that time, consideration should be given to the fact that the then elected Labour government wanted to avoid radical changes, as it did not want to risk alienating business interests (Ferran, 2001: 17), which policy it had itself confirmed (DTI, March 1998: paragraph 7.5).

A proposal therefore to transpose the rationale of the provision in the Corporate Governance Code is not only in line with the market-based tradition of UK corporate governance, i.e. 'comply or explain', but also constitutes a proactive form of regulation at a stage in time when the events that are likely to follow the political effects of BREXIT demand it. The UK's withdrawal from the EU will result in non-direct effect and non-applicability of EU company legislation, so the political need to 'sell' the UK as a 'business friendly' environment will emerge (House of Commons, Business, Energy and Industrial Strategy Committee, 2017). The promotion of such an objective includes the need to show case that the UK encourages corporations to incorporate relevant sustainability, ESG (environmental, social and governance), the UN's Sustainable Development Goals (SDGs) and CSR (corporate social responsibility) considerations in developing their long-term strategies and operations planning. The UK's withdrawal from the EU is also likely to result in stakeholders being even less likely than before to be given a central place in the government's agenda. It is unlikely that stakeholders will feature as the main actors in hard

law legislation, as more progressive scholars may have hoped for.<sup>5</sup> At the same time, recent corporate scandals, including the *BHS* scandal, have put pressure on the elected Government to proactively address the corporate failures through more regulation, so the proposal put forward by this chapter may in fact a good compromise that may produce some of the desired effects of companies' better governance.

## IV. Conclusion

Continuing with the inclusion of section 172 in the Companies Act 2006 as a safeguard for stakeholders' interests is futile. Not so much because the section prioritises shareholders' interests over stakeholders' interests, but because the mode of regulation that the Company Act employs does not provide the substantive content of this section with the visibility that is necessary for it to be functionally a viable way of stakeholders' featuring in corporate decision-making as a matter of best practice. Section 172 CA 2006 gives the illusion to the business community, regulators, certain scholars, and market players alike, that something is being done in the sphere of company law in relation to acknowledging stakeholders' interests in corporate decision-making. As the chapter has advocated, this is far from being the case. The proposal also aligns with the BEIS Committee's proposal following the response to the Corporate Governance Green Paper, which recommends to the FCA to amend the Code to require information narrative reporting on the fulfilment of section 172 CA 2006 duties (House of Commons, Business, Energy and Industrial Strategy Committee, 2017: 60, conclusion no 5). The proposal put forward by this chapter is one which in the author's view adequately reflects the reality of how the UK regulatory market is accustomed to operating and should only be seen as *one* of a range of tools the government should put in place to strengthen stakeholders interests in companies. Making alternations for example on the issue on which parties are allowed to monitor whether the Code has been complied with and on what basis could also complement this proposal.<sup>6</sup> Recently, recommendation has also been made by the BEIS Committee that the FCA is provided with additional powers so as to hold

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<sup>5</sup> See example of backtracking on employee participation on boards as advocated by PM Theresa May in her governmental speech in July 2016 compared to the Green Paper November 2016 proposal introducing optional committees comprised of employees.

<sup>6</sup> See argument put forward at Cass Business School and Frank Bold Law Firm, London, Corporate Reporting event, 7<sup>th</sup> June 2017, that monitoring of compliance with the Code should not only in the hands of shareholders, but also in the hands of other stakeholders, who, as Professor Charlotte Villiers argues may have greater incentives to monitor.

to account company directors in respect of the full range of their duties and specifically section 172 CA 2006 (House of Commons, Business, Energy and Industrial Strategy Committee, 2017: 61, conclusion no 8). Other initiatives, as are the introduction of new corporate formats for cooperatives and social enterprises, all fall within the agenda of changing the current status quo followed in UK corporate governance to a more progressive one.

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